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Supreme Court of the United States

OCTOBER TERM, 1940.

No. 436.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

ESTATE OF JOHN M. ENRIGHT, deceased, JAMES G. ENRIGHT, EMMA E. NEILSON and MILDRED L. ENRIGHT, Executors.

ON PETITION FOR WRIT OF CERTIORARI TO THE CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

BRIEF FOR THE RESPONDENTS IN OPPOSITION.

JAMES D. CARPENTER, JR.,
Of Counsel with Respondents.

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Supreme Court of the United States

No. 436, October Term, 1940.

Guy T. Helvering, Commissioner of Internal Revenue, Petitioner, *vs.* Estate of John M. Enright, deceased, James G. Enright, Emma E. Neilson and Mildred L. Enright, Executors.	On Petition for Writ of Certiorari to the Circuit Court of Appeals for the Third Circuit.

BRIEF FOR THE RESPONDENTS IN OPPOSITION.

Opinion Below.

The opinion of the Circuit Court of Appeals is reported in 112 Fed. (2d) 919.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered June 17, 1940. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

Questions Presented.

(1) Whether a partner's share of the estimated value of the gross assets of a partnership, consisting of legal services rendered, the value of which is neither known or due and payable to the partnership, should be included in

the gross income of the partner for the period ending with his death under Section 42 of the Revenue Act of 1934, where both the partnership and the deceased partner were on the cash basis.

(2) Whether the words "income accrued", as used in Section 42 of the Revenue Act of 1934, include in their meaning a deceased partner's interest in the gross assets of a law partnership, where such assets consist of legal services partly rendered and do not constitute an accrual to the partnership even if it maintains its books of account on an accrual basis.

Statutes and Regulations Involved.

Revenue Act of 1934, C. 277, 48 Stat. 680:

Subtitle A—Introductory Provisions.

* * * * * * *

"SEC. 4. SPECIAL CLASSES OF TAXPAYERS.

The application of the General Provisions and of Supplements A to D, inclusive, to each of the following special classes of taxpayers, shall be subject to the exceptions and additional provisions found in the Supplement applicable to such class, as follows:

(a) Estate and trusts and the beneficiaries thereof —Supplement E.

(b) Members of partnerships,—Supplement F.

(c) Insurance companies,—Supplement G.

(d) Nonresident alien individuals;—etc." (U. S. C. A. Title 26, Sec. 4.)

Subtitle B—General Provisions.

* * * * * * *

"SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includable in respect of such period or a prior period (U. S. C. A. Title 26, Sec. 42)."

Subtitle C—Supplemental Provisions.

* * * * * *

Supplement F—Partnerships.

"SEC. 181. PARTNERSHIP NOT TAXABLE. Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity (U. S. C. A. Title 26, Sec. 181).

"SEC. 182. TAX OF PARTNERS. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year (U. S. C. A. Title 26, Sec. 182).

"SEC. 183. COMPUTATION OF PARTNERSHIP INCOME. The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual (U. S. C. A. Title 26, Sec. 183)."

Statement.

A few facts in addition to those mentioned in the Government's petition should be before the Court

Shortly after Enright's Executors qualified, they and the senior surviving partner made a survey of decedent's assets. They then agreed that the interest of Enright in

his law partnership should be liquidated case by case, and the amount of his interest should be paid to the executors from time to time, at the convenience of the successor firm. That was done (R., pp. 35, 43, par. 10).

The senior surviving partner appraised the accounts receivable of the firm and decedent's interest in the unfinished cases in the office for the purposes of estate taxes (R., p. 36). Practically all matters in the office were being handled on the *quantum meruit* basis. The appraisal was completed in November, 1935 (R., p. 37).

There were approximately four hundred matters in the office. Some of them were on appointment by the court to represent receivers, trustees and administrators, and in such matters the fees are fixed by order of the court after the work has been done (R., p. 36).

The appraisal that was thus made for Federal estate and transfer inheritance tax purposes of the value of Enright's interest in his firm, was $42,911.32. In making the assessment the Commissioner held that this amount "has been included in the gross income of the decedent as income accrued up to the date of his death, under the provisions of Section 42 of the Revenue Act of 1934" (R., p. 13, par. (b)).

As each case was closed and the fee paid, the senior surviving partner re-examined the charge sheets to ascertain whether the amount originally determined as the interest of Enright therein to the date of death was correctly stated. In fifty-five separate cases the amount was increased; in twenty cases the amount estimated was decreased (R., p. 47).

The interest of decedent at the date of death in the cash on hand in the firm bank accounts was $4,143.81, which was included in the income tax return filed by the executors for the calendar year 1934 as income accrued to the date of

death and the tax was paid thereon, although said sum was not actually distributed by the successor firm to the executors until February 26, 1935 (R., p. 42, par. (6)).

REASONS FOR DENYING THE WRIT.

I.

The Decision of the Circuit Court of Appeals for the Third Circuit is in conformity with the letter, purpose and intent of the Revenue Act.

The deficiency assessment in this case results from the inclusion, by the Commissioner of Internal Revenue, in the gross income of decedent for the year 1934 of

(a) His interest in the accounts receivable of the partnership, and

(b) His estimated interest in fees earned in whole or in part by the partnership, but not billed to or received from clients of the partnership.

In making this assessment, the Commissioner contends that the above interests of decedent constitute amounts accrued to decedent up to the date of his death within the meaning of the 1934 Amendment to Sec. 42 of the Revenue Act, which reads:

> "In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death amounts accrued up to the date of his death if not otherwise properly includable in respect of such period or a prior period."

The partnership kept its books of account on a cash basis, as did decedent. The partnership agreement ex-

pressly provided that the individual partners should receive from the partnership only their share of the actual cash collected by the partnership.

The inclusion in the gross income of decedent of his interest in the accounts receivable of the partnership in effect required the partnership as such to change its books of account from a cash basis to an accrual basis.

The inclusion in the gross income of decedent of his interest in fees earned in whole or in part by the partnership, but not billed to or received from clients of the partnership, in effect required the estate of decedent to report as accrued income that which was not in fact even accrued income to the partnership under any method of accounting.

The Board of Tax Appeals affirmed the action of the Commissioner in a memorandum opinion, which was reversed by the Circuit Court of Appeals for the Third Circuit in 112 Fed. (2d) 919.

In its opinion, the Third Circuit Court of Appeals agreed with the Board of Tax Appeals that the effect of Section 42 of the Revenue Act "was to require that deceased be placed upon an accrual basis at the date of his death", and held that as a necessary consequence of this effect:

> "* * * decedent's taxable income should have been computed in the same way it would have been had he been alive and regularly making his returns upon the accrual basis."

With regard to the erroneous reasoning of the Board of Tax Appeals in affirming the action of the Commissioner, Judge Maris in the court below said:

> "We think the Board fell into error in failing to treat the partnership as a tax computing unit separate from its member, Enright. That the Revenue

> Act requires that a partnership be so treated is clear from its provisions for the computing of partnership income and the filing of partnership returns and has been recognized by the courts. Thus a partnership may make its return for a taxable year different from that of its members, and it may likewise make its return upon an accounting basis different from that used by the individual partners."

That the Circuit Court of Appeals correctly construed Section 42 as amended, is evident from the arrangement of the Revenue Act. Section 4 provides that the general provisions of the Act are subject to the special provisions in the Act with respect to certain classes of taxpayers.

Section 42, relied upon by the Commissioner in making the deficiency assessment in this case, is included in the title "General Provisions."

Sections 181 to 188 inclusive, apply to one of the special classes of taxpayers referred to by Section 4, to-wit, Partnerships.

So that, as to a partnership as such, its method of accounting, its computation of the distributive shares of its partners, etc., the provisions of Sections 181 to 188 are controlling and Section 42 has no application.

Accordingly, where the partnership is on a cash basis, a deceased partner's executor, under Section 182, is bound to report only his distributive share of the cash basis net income of the partnership at his death. He is not bound to report the deceased partner's share of all the partnership accrued income on the theory that it is cash on hand available for distribution. For stronger reasons, the executor is not required to report as income accrued, the deceased partner's share of that which is not even accrued income to the partnership, as the Commissioner determined in this case.

Section 182 has for years been a special section of the Revenue Acts applying to a special type of gross income, while Section 42 is a general provision of the Tax Act of 1934, applicable to all types of income, not otherwise specifically provided for in the Act. It is submitted that inasmuch as Congress did not alter or amend Section 182 at the time of the enactment of the 1934 Amendment to Section 42, the latter section as amended has no application to this special type of gross income, to-wit, the *distributive share* of a partner in the income of the partnership.

The purpose of Section 42 was merely to effect the change in the individual method of accounting where the taxpayer died during the taxable year. It was not intended to affect potential income which the taxpayer would have had no right to receive even if he had employed the accrual method of accounting during his lifetime.

What constitutes accrued income to a taxpayer at his death, who during his lifetime had regularly employed the cash receipts and disbursements method of accounting, is controlled by what would have constituted his income had he lived and used the accrual method of accounting in keeping his books.

Fehrman vs. *Commissioner*, 38 B. T. A. (No. 7) (1938).

In *Guaranty Trust Co.* vs. *Commissioner*, 303 U. S. 493, Mr. Justice Stone said:

> "Receipt of income or accrual of the right to receive it within the tax year is the test of taxability, not the time it has taken the taxpayer to earn it, nor the duration of his investments which have finally resulted in profit. Lucas *vs.* Alexander, 279 U. S. 573.

"The Revenue Acts have consistently adhered to that policy in taxing the income of a partner. Since the partner is entitled to profits only upon a partnership accounting at the end of the accounting period, his profits become subject to income tax when and as they are thus ascertained."

It is contended in the petition before this court that Congress, by Section 42 of the Revenue Act, intended to tax to decedent all income earned during his lifetime.

There is nothing in the 1934 amendment to Section 42 of the Revenue Act, or in the report of the Ways and Means Committee of the House, or the report of the Finance Committee of the Senate indicating any such intention.

II.

The decision of the Circuit Court of Appeals for the Second Circuit, affirming the decision of the Board of Tax Appeals in *Pfaff, et al., Executors of Wallace* v. *Commissioner,* is clearly wrong.

The decision, in *Pfaff* vs. *Commissioner* (*supra*) cited by the Commissioner as in conflict with the decision of the court below, is reported at 113 Fed. (2d) 114. A petition for a writ of certiorari to review the judgment in the *Pfaff* case has been filed in this court and is docketed as No. 479.

The Circuit Court of Appeals for the Second Circuit in deciding the *Pfaff* case fell into error in failing to treat the partnership as a tax computing unit separate from its member Wallace; and also in treating as income accrued services partly rendered by the partnership which had not even been billed. Consequently, the income had not even accrued to the partnership.

Conclusion.

It is respectfully submitted that the case at bar was correctly decided below, and that the writ of certiorari as prayed for herein should be denied.

Respectfully submitted,

JAMES D. CARPENTER, JR.,
Of Counsel with Respondents.

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